

SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Wesson, et al. Analyst: Marion Mann DeJong Bill Number: AB 2747

Related Bills: See Prior Analysis Telephone: 845-6979 Amended Date: 06/20/2002

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Motion Picture Production Wages Paid Credit

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

☒ FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED _____ STILL APPLIES.

☒ OTHER - See comments below.

SUMMARY

This bill would create an income tax credit for wages paid in connection with the production of a motion picture in California. If unable to use this credit, the taxpayer could:

- assign the credit to another taxpayer;
- apply the income tax credit against any sales or use taxes owed; or
- receive a refund of any sales or use taxes paid.

SUMMARY OF AMENDMENT

The June 20, 2002, amendment deleted the prior version of the credit and replaced it with credit language that resolved many of the department's concerns. Department staff is working closely with the authors and the Governor's office to help them create a credit that meets the needs of industry but that can be administered by the department.

The "Purpose of the Bill," "Federal/State Law," "Legislative History," and "Other States' Information" discussions from the department's analysis of the bill as amended April 18, and April 30, 2002, still apply. The remainder of that analysis and the department's analysis of the bill as amended May 16, 2002, is replaced with the following.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Legislative Director

Date

Brian Putler

07/01/02

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. However, the bill specifies that it would be operative for taxable years beginning on or after July 1, 2004, and before January 1, 2010.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are needed to resolve the implementation concerns discussed in this analysis before the bill can be implemented by the department. Department staff is working with the authors and the Governor's office to resolve these issues and will provide amendments directly to the author's staff. Technical amendments are provided below.

ANALYSIS

THIS BILL

This bill would create an income tax¹ credit equal to 15% of wages paid in connection with the production of a motion picture in California. Only one taxpayer, the copyright owner or an entity designated by the copyright owner, would be eligible for the credit with respect to each motion picture. In the event a taxpayer was unable to use some or all of an earned credit, the taxpayer could elect to assign any portion of the unused credit to members of the same controlled group. Alternatively, the taxpayer could elect to apply the income tax credit against a sales or use tax liability or request a refund of sales or use tax already paid equal to the income tax credit.

The credit would equal 15% of wages paid to qualified individuals during the production period of a motion picture for which production was either completed or all activity ceased during the taxable year. For each motion picture, the maximum amount of wages per qualified individual that can be taken into account in computing the credit is \$25,000.

The credit would be allowed for taxable years beginning on or after July 1, 2004, and before January 1, 2010. Motion picture productions completed or ceased prior to the taxpayer's first taxable year beginning on or after July 1, 2004, would qualify for the credit. However, for these motion pictures only wages paid on or after January 1, 2004, would qualify for the credit and the credit would be claimed on the taxpayer's tax return for the first taxable year beginning on or after July 1, 2004.

¹ This bill would provide a credit under both the income tax and the franchise tax. For purposes of this analysis, the reference to "income tax" includes the "franchise tax."

“Qualified individuals” would be individuals who perform services during the production period in an activity related to the production of a motion picture. Wages paid to individuals related to the taxpayer would not qualify for the credit. Wages qualifying for the credit would include:

- W-2 wages paid by the taxpayer to a qualified individual on or after January 1, 2004, for services performed in California.
- Employee fringe benefits that are allocable to the W-2 wages described above.
- Payments made to an entity (i.e., personal service corporations, payroll service corporation, or any entity receiving wages on behalf of a qualified individual) on or after January 1, 2004, for services performed in California by qualified individuals.
- Remuneration paid on or after January 1, 2004, to independent contractors who are qualified individuals for services performed in California.

Costs paid for various activities specified in the bill that are unrelated to the production of a motion picture would be excluded from wages that qualify for the credit.

“Production period” would mean the period commencing with approval to proceed with the production project and ending with delivery of the completed qualified motion picture. In the event the qualified motion picture is not completed, the “production period” ends when all activity on the project ceases.

Motion pictures qualifying for the credit would be motion pictures as defined in Section 6010.6(b)(3) of the Revenue and Taxation Code (the sales and use tax law) that meet both of the following additional requirements:

- The total cost of wages of the motion picture, excluding specific costs, is more than \$200,000, but less than \$10 million. These amounts will be indexed annually for inflation. For purposes of this test, each episode of a television series is considered to be a separate motion picture.
- At least 50% of the total wages of the production are wages that qualify for the credit.

If the wages under this section also qualify for a different income tax credit, the taxpayer would be allowed to claim only this credit for those wages. However, wages paid to qualified individuals in excess of the amount providing the basis for a credit under the bill would be available for purposes of other credits. Excess credit amounts could be carried forward up to eight years. The taxpayer would be required to reduce any deductions claimed for wages paid or incurred with respect to a motion picture by the amount of the credit claimed or assigned.

If the taxpayer is unable to use some or all of an earned credit, the taxpayer may elect to assign any portion of the unused credit to members of the same controlled group. “Controlled group” would mean all entities that are under common control. “Control” would mean the ability of any person, as a corporate parent or other entity, to direct the policies or actions of another entity through stock or other ownership.

An election to assign the credit is irrevocable once made and must be made on a timely filed original return for the taxable year in which the assignment is made or an information return filed quarterly as specified by the Franchise Tax Board (FTB). The election must identify the assignee and the assignee's taxpayer identification number. The assignor and assignee must complete a written agreement that:

- Specifies the amount of credit being assigned to the assignee and the taxable year that the credit was originally allowed to the assignor.
- Specifies that the assignor and assignee agree that they shall be jointly and severally liable for the assigned credit amount.
- Specifies that both the assignor and assignee agree to allow the FTB to disclose to either party confidential tax information of the other party that would be necessary to defend action taken by FTB with respect to the assigned credit.

The assignee may first claim the assigned credit for the taxable year in which the assignment is made. Any assigned credit amounts not used in that taxable year may be carried forward for the remaining carryover period allowed to the assignor.

The bill would allow FTB to perform a single audit of the credit claimed by either the assignor or any assignee, with a single proposed adjustment, protest, and appeal rights. Final adjustment based on that single audit would be the basis for any adjustment of the credit on the return of any other party to the assignment without further protest or appeal rights for the assignor or assignee even if there were no protest or appeal of the proposed adjustment. In other words, the bill prevents multiple audits and multiple opportunities for protest and appeal for the same credit amount. In addition, the bill would allow FTB to collect any taxes attributable to the adjustment of an assigned credit from either the assignor or assignee.

The bill would specify that the credit would be denied unless the taxpayer or assignee substantiates by adequate records or sufficient evidence that the wages were paid.

IMPLEMENTATION CONSIDERATIONS

Department staff has identified the following implementation considerations. Additional concerns may be discovered as the bill is further refined and moves through the legislature. Department staff is working with the authors and Governor's office to resolve these issues.

- This credit is allowed to one taxpayer, but is based upon wages paid by many taxpayers (contractors and subcontractors actually producing the motion picture) during the production period of a motion picture. Taxpayers must share wage information with the copyright owner of the motion picture to determine if the motion picture qualifies for the credit and to compute the credit amount. Without this sharing of wage information, the credit cannot be implemented. However, according to the sponsors of this bill, industry practices and production contracts will be modified to require the sharing of this information. Thus, according to the sponsors, determining if a motion picture qualifies and computing the credit amount should not be a problem. Further, the substantiation requirement is apparently intended to preclude assertions by the qualified taxpayer that they are unable to obtain the necessary wage information but should still be entitled to claim this credit.

- It is unclear what happens if the legal title to the motion picture is sold during the production period or thereafter. Must the qualified taxpayer incur the expenses while holding the copyrights in order to claim the credit? If the qualified taxpayer incurs expenses that would otherwise qualify for the credit, but then sells the motion picture title rights prior to being entitled to claim the credit (such as because the expenses are incurred prior to July 1, 2004), would that taxpayer still be entitled to claim the credit? This issue may be resolved as the bill is amended to clarify that the taxpayer claiming the credit is not the taxpayer that incurs the wage expenses.
- The bill allows a taxpayer to elect to apply the income tax credit against a sales or use tax liability or request a refund of sales or use tax already paid equal to the income tax credit. However, the bill does not specify what is to be done if the income tax credit is partially or completely disallowed in a subsequent audit by the department. Further, the sales and use tax refund provision refers to the Board of Equalization's authority to recover any "erroneous" refund, but it is unclear whether a determination by the department would constitute an "erroneous" refund within the meaning of the law administered by the Board of Equalization. Finally, it is unclear whether erroneous refund amounts could be recovered if the statute of limitations expired for sales tax purposes but remains open for income tax purposes. The bill should specify how the income tax credit and the election to receive a sales tax refund are intended to be coordinated. In addition, the bill should specify which agency (the department or the Board of Equalization) is to make the determination of whether a sales or use tax refund that has been granted is considered "erroneous" and thus capable of recovery through the sales tax "erroneous" refund authority, as well as the intended statute of limitations period.
- The sales and use tax provisions require the taxpayer to provide a copy of the personal income or corporation tax return showing the income tax liability when requesting a sales tax refund or credit. It is unclear what the requirement is intended to accomplish. Since the credit would only be shown on the income tax return for the year that it is used, not the year it is generated, the credit might not be shown on the income tax return if the credit were not being used. For example, a taxpayer that has net losses would not have a tax liability and thus could not use the income tax credit. The credit might not be shown on the income tax return.
- If the credit is disallowed only in part, it is unclear how this disallowance would be allocated between the assignor and the assignee, especially if the statute of limitations has expired for one, but not both, of the affected taxpayers.
- The definition of "production period" may be difficult to implement without clarification of who gives approval to proceed with the production and how the delivery of the completed project occurs. It is unclear to department staff whether these are definitive events that can be specifically identified as occurring on a particular calendar date. If they are definitive events, staff can be trained to understand the production period. However, if these are subjective events that cannot be specifically identified as occurring on a particular calendar date, then disputes are likely to occur between taxpayers and the department. Further, for productions that are incomplete, defining "all activity" for purposes of when a project ceases would avoid taxpayer confusion and disputes between taxpayers and the department. Finally, in the case of incomplete productions, it may be impossible for the department to adequately verify whether a production is "ceasing" solely for purposes of avoiding the \$10 million wage cost limitation and then being restarted under a slightly different name to qualify the entire production (both the ceased production and the ultimately completed production(s)).

- The requirement that the taxpayer reduce any wage deduction by the amount of the credit cannot be implemented. An expense deduction is claimed on the tax return for the year in which the expense is incurred and is claimed by the taxpayer that paid the expense. This credit is based upon wages paid over the production period and is claimed after production is complete by the copyright owner, regardless of whether the owner directly paid the wage expense and regardless of whether the wage was paid in the same taxable period in which production is completed. For these reasons, the taxpayer that claims the credit may not be the same taxpayer that claims the expense deduction. In addition, the wage expenses may be deducted in a different tax year than the tax year in which the credit is claimed.

Further, conflicting tax policies come into play whenever a credit is provided for an expense item for which preferential treatment is already allowed in the form of an expense deduction. Although this bill would require an adjustment to limit deductions in order to eliminate a double tax benefit, this creates a federal and state difference, which is contrary to the state's general federal conformity policy.

- This bill defines controlled group as entities under common control (e.g., the ability to direct policies or actions). This definition would potentially allow for manipulation of the group for purposes of assigning the credit. For example, in some situations 5% ownership may give a taxpayer the ability to direct policies or actions. It is department staff's understanding that this definition was provided by the author to allow a corporate partner to assign the credit. Department staff is working with the author to define controlled group by reference to Section 25105, and to allow the assignment of the credit by corporate partners.
- Department staff is working with the authors to refine the credit assignment provision. Issues still pending that are not addressed above include a requirement that the assignment agreement be attached to the tax return rather than provided upon request and requiring the disclosure of the amount of credit assigned in the contract. Furthermore, adopting the concept of assigning the credit attributable to a particular motion picture rather than the credit for a particular year may reduce complexities related to administration of an assigned credit.

In addition, department staff is requesting that the author remove the provision allowing taxpayers to elect to assign a credit on a quarterly information return rather than on the income tax return. The department would incur additional costs to process these information returns. According to the sponsor, this provision was added to ensure that assignments could be made prior to the close of a taxable year. The requirement that the assignment be made on a timely filed original return would accomplish the author's goal of allowing assignments made at any time during that taxable year

TECHNICAL CONSIDERATIONS

The use of the phrase "appropriate amount" is unnecessary and may lead to disputes between taxpayers and the department. Amendments 1 and 4 would remove this phrase and delete the extra word "on."

Now that the author has defined the activities that are excluded from production, department staff realizes that "expenses, including wages," rather than "wages," is more appropriate in the list of items not included in qualified wages. Amendments 2 and 5 would make this change.

Since the Personal Income Tax (PIT) credit is not assigned, "or the assignee" should be removed from the record requirement in the PIT credit. Amendment 3 would make this change.

FISCAL IMPACT

Assuming that the department would review the credit only during the normal audit cycle, this bill would not significantly impact the department's costs. If the legislature intends for the department to review the credit prior to the normal audit cycle (i.e., prior to the issuance of a sales or use tax refund, or income tax refund) the fiscal impact to the department would be significant.

ECONOMIC IMPACT

Because the authors have indicated that the bill will be further amended to resolve the department's implementation concerns, an estimate of the economic impact will not be provided at this time. Department staff is working closely with the authors and Governor's office to provide them with input regarding the economic impacts of various alternatives for resolving the issues associated with this credit.

ARGUMENTS/POLICY CONCERNS

- Under existing state law, credits are only available to the taxpayer that incurred the expense that provided the basis for the credit. This credit would allow a taxpayer to claim a tax credit for wages incurred during the production of a motion picture they held title to regardless of whether the taxpayer actually paid the wages.
- This bill allows the credit to be used by any member of a commonly-controlled group, irrespective of whether that group is a unitary group or not. Only the low-income housing credit permits a corporation to assign all or a portion of its low-income housing credit to one or more affiliated corporations and only under extremely narrow circumstances (100% common ownership). Furthermore, the Governor vetoed legislation (AB 1903, Lowenthal, 1999/2000) that would have allowed the low-income housing credit to be used by taxpayers with no economic responsibility for the expenses that provided the basis for that credit.

The sponsor of the bill suggests that the credit should be shared; similar to how it would be done for federal consolidated return purposes. However, California law does not allow the filing of consolidated returns by affiliated corporations. Instead, affiliates that file a combined report retain their separate tax identity and liability for only their own taxes. Generally, items such as net operating loss carryovers and credits are not shared among the members of the combined group. If state tax policy is to be changed to allow this credit to be applied against the tax liability of other members of the combined group, perhaps a similar change in state tax policy should be considered for all credits.

Some who support the policy of a combined group's use of credits have done so using the rationale that the investment that gave rise to the credit is economically a group investment. That rationale would support apportionment of credits to *all* members of the combined group, even those that are not California taxpayers.

- It may be more cost efficient administratively and probably easier administratively for the department if the Legislature were to enact a refundable income tax credit rather than a credit that can be assigned to another taxpayer or indirectly refunded via the sales or use tax.

- This credit is indirectly refundable via the sales and use tax refund portion of the bill. Historically, refundable credits (such as the state renter's credit, the federal Earned Income Tax Credit, and the Federal Tax Paid on Fuels credit) have had significant problems with fraud. These problems may be further exacerbated because this credit would be earned under the income tax laws, administered by the Franchise Tax Board, and refunded under the sales and use tax laws, administered by the Board of Equalization.
- This bill could be considered inequitable to some taxpayers because taxpayers with fiscal years beginning between July 1 and December 1 would be eligible for the incentive for seven taxable years while those with fiscal years beginning between January 1 and June 1 would be eligible for the incentive for only six taxable years.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2747
As Amended June 20, 2002

AMENDMENT 1

On page 4, modify line 13 as follows:

on other than ~~on~~ a "per episode" basis, ~~an appropriate amount of~~

AMENDMENT 2

On page 7, modify lines 8 through 16 as follows:

(i) ~~Wages~~ Expenses, including wages, for legal or accounting services, except for legal or account services performed by production employees.

(ii) ~~Wages~~ Expenses, including wages, related to new use, reuse, clip use, licensing, secondary markets, or delayed residual compensation, or the creation of any ancillary product, including, but not limited to, a soundtrack album, toy, or game.

(iii) ~~Wages~~ Expenses, including wages, paid or incurred with respect o acquisition, development, turnaround, or any rights thereto.

(iv) ~~Wages~~ Expenses, including wages, related to marketing, promotion, or distribution of

AMENDMENT 3

On page 7, line 40, delete "or the assignee"

AMENDMENT 4

On page 9, modify line 2 as follows:

on other than ~~on~~ a "per episode" basis, ~~an appropriate amount of~~

AMENDMENT 5

Modify page 11, line 36 through page 12, line 5 as follows:

(i) ~~Wages~~ Expenses, including wages, for legal or accounting services, except for legal or account services performed by production employees.

(ii) ~~Wages~~ Expenses, including wages, related to new use, reuse, clip use, licensing, secondary markets, or delayed residual compensation, or the creation of any ancillary product, including, but not limited to, a soundtrack album, toy, or game.

(iii) ~~Wages~~ Expenses, including wages, paid or incurred with respect o acquisition, development, turnaround, or any rights thereto.

(iv) ~~Wages~~ Expenses, including wages, related to marketing, promotion, or distribution of